

BUY

TP: Rs 650 | ▲ 27%

HCL TECHNOLOGIES

| IT Services

| 07 May 2020

First among equals

HCL Tech (HCLT) ended FY20 on a strong note with 0.8% QoQ CC and 13.4% YoY CC topline growth and five-year-high EBIT margins of 20.9% in Q4FY20. With 14 large transformation contract wins, the company saw its best deal quarter for the year. Management expects a revenue decline in Q1FY21 (similar to peers). We trim FY21/FY22 EPS by 8%/6% and revise our Mar'21 TP to Rs 650 (vs. Rs 690). We believe the software business, healthy deal wins and cloud/infrastructure expertise offer better near-to-mid-term growth visibility than peers.

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Q4 performance ahead of peers: With sequentially flat dollar revenues (and 0.8% QoQ CC growth), HCLT reported the most resilient topline in Q4FY20 among large peers (which posted dollar revenue contraction in the range of 1-4.3% QoQ). EBIT margins at 20.9% marked a five-year high and inched up 60bps QoQ, aided by currency tailwinds and operational efficiency in the IT business.

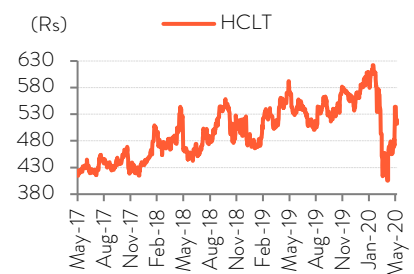
Mode-3 to de-risk portfolio: The software business unit (represented by the mode-3 segment) continued to do well and was largely immune to Covid-19 adversities in Q4. Management stated that deal renewal velocity maintains healthy momentum. Mode-2 (digital segment) led the way at 5.5% QoQ dollar growth. Mode-2 and 3 now from 35% of total revenue from 29.5% last year.

Reassuring capital allocation and healthy balance sheet: HCLT announced dividend of Rs 2/sh (on double the number of shares post the 1:1 bonus issue) and assured investors of continuity in quarterly dividend payouts.

Management's unshaken commitment to honor the US\$ 800mn IBM product payment installment on time (Jun'20) highlights a healthy balance sheet. HCLT had US\$ 2bn in gross cash and US\$ 673mn in borrowings as at end-Q4FY20.

Ticker/Price	HCLT IN/Rs 512
Market cap	US\$ 18.3bn
Shares o/s	2,713mn
3M ADV	US\$ 39.5mn
52wk high/low	Rs 624/Rs 375
Promoter/FPI/DII	60%/27%/13%

Source: NSE

STOCK PERFORMANCE

Source: NSE

KEY FINANCIALS

Y/E 31 Mar	FY18A	FY19P	FY20E	FY21E	FY22E
Total revenue (Rs mn)	5,05,700	6,04,280	7,06,780	7,51,305	8,09,309
EBITDA (Rs mn)	1,14,400	1,40,020	1,66,930	1,74,856	1,99,830
Adj. net profit (Rs mn)	87,820	99,757	1,10,940	1,06,708	1,24,738
Adj. EPS (Rs)	31.5	36.7	40.9	39.3	46.0
Adj. EPS growth (%)	5.4	16.3	11.5	(3.8)	16.9
Adj. ROAE (%)	26.5	25.4	23.7	19.6	20.6
Adj. P/E (x)	16.2	14.0	12.5	13.0	11.1
EV/EBITDA (x)	12.1	9.8	8.2	7.9	6.8

Source: Company, BOBCAPS Research

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Earnings call highlights

■ Management outlook

- The pipeline looks healthy going into FY21 and HCLT's order book is up significantly YoY. Short-term business drivers include (1) a fluid digital workplace, (2) digital transformation acceleration, (3) cloud consumption, (4) cyber-security, (5) engineering services, and (6) digital channels for BFSI. The biggest opportunity will emerge from life sciences and healthcare.
- Within manufacturing, the automobiles and aerospace sub-verticals will face a severe adverse impact due to the economic lockdown. Entertainment-media and non-essential retail will also be affected. Within life sciences, pharma and payers remain somewhat insulated, while providers and medical devices have been hit. The technology vertical continues to see good momentum. BFSI and telecom are also being viewed as low impact verticals.
- HCLT is gaining market share due to vendor consolidation.
- Management expects revenue contraction in Q1FY21 while Q2 and Q3 should see a growth pickup. In the worst-case scenario of a resurgence of the virus, revenue may stabilise in Q2 and pick up only in Q3.

- **Operating margins:** EBIT margin expanded 60bps QoQ and 170bps YoY in Q4 to a five-year high of 20.9%, backed by stronger gross margins. Tailwinds of 53bps from INR depreciation and 22bps from increased productivity in the IT business aided QoQ margin expansion. For FY20, EBIT margin stood at 19.6%, a shade higher than the guided range of 19.0-19.5%. Going forward, increased utilisation and lower variable payouts will help in cost optimisation.

- **IBM product suite:** HCLT continued to modernise the IBM product suite by launching new versions of Appscan, Unica and Bigfix (products acquired from IBM). Bigfix and Appscan are seeing the largest number of new customer additions due to increased cybersecurity demand.

■ Covid-19 impact

- About 96% of HCLT's global employees are currently working from home and 2.5% are working out of offices. The company had started risk management towards late-Jan'20, limiting the supply crunch related loss (1.5% loss of billing/revenue in Q4FY20). A total of 3.5mn of its clients' employees were enabled to work from home taking into account security-related concerns. As many as 99% of HCLT's clients rated its services as 'very effective'.

- Customers are asking for payment term extensions. Discretionary spend is not being deferred but some impact is visible in the B2B segment. Deal execution delays and demand for price discounts are expected.
- Capacity expansion has been completed in the life sciences segment.
- **Miscellaneous**
 - HCLT has posted a strong FY20 performance – revenue grew 16.7% CC, within the revised guidance range of 16.5-17%. Organic growth at 10.7% CC lay within the guided range of 10-11%. EBIT margin at 19.6% exceeded the guided range of 19-19.5%. Demand for fluid workplace solutions on the infrastructure side aided growth in FY20. YoY growth was broad-based with three of seven verticals growing in double digits – IT and business services grew at 12.7%, the ERS business grew 12.8% and products & platforms increased 60.5% (all CC).
 - For Q4FY20, Europe/APAC revenues declined 1.7%/2.5% QoQ in dollar terms. Life sciences, energy – utilities, and technology services grew 2.5%, 1.9% and 7.3% respectively. Media, publishing & entertainment saw the highest QoQ decline of 7.8%.
 - Management is targeting margin gains in Mode-3, but expects amortisation cost and increased sales and marketing expenses to keep margins at ~30%.
 - Proportion of fixed price contracts increased by 50bps QoQ, which should provide protection against volatility.
 - The US\$ 100mn+ client bucket grew 50% YoY.
 - HCLT is looking to expand into Sri Lanka and Vietnam to de-risk its offshore presence.
 - 1,250 employees were added QoQ (net).

FIG 1 – MAR'20 QUARTER PERFORMANCE

(Rs mn)	Q4FY20	Q4FY19	YoY (%)	Q3FY20	QoQ (%)	FY20	FY19	YoY (%)
Revenues (US\$ mn)	2,543	2,278	11.7	2,543	0.0	9,936	8,632	15.1
Revenue	1,85,900	1,59,900	16.3	1,81,350	2.5	7,06,780	6,04,280	17.0
Operating Expenditure	1,38,700	1,23,600	12.2	1,36,650	1.5	5,39,850	4,64,260	16.3
Cost of revenues	1,11,510	1,01,340	10.0	1,11,760	(0.2)	4,43,080	3,89,810	13.7
as % of sales	60.0	63.4	-	61.6	-	62.7	64.5	-
SG&A expenses	27,190	22,260	22.1	24,890	9.2	96,770	74,450	30.0
as % of sales	14.6	13.9	-	13.7	-	13.7	12.3	-
EBITDA	47,200	36,300	30.0	44,700	5.6	1,66,930	1,40,020	19.2
Depreciation	8,390	5,580	-	8,000	-	28,400	21,480	32.2
EBIT	38,810	30,720	26.3	36,700	5.7	1,38,530	1,18,540	16.9
Other Income	(130)	1,190	-	670	-	1,790	7,720	(76.8)
PBT	38,680	31,910	21.2	37,370	3.5	1,40,320	1,26,260	11.1
Total Tax	7,070	6,150	-	6,910	-	29,380	24,810	18.4
Adjusted PAT	31,610	25,760	22.7	30,460	3.8	1,10,940	1,01,450	9.4
(Profit)/loss from JV's/Ass/MI	(80)	(80)	-	(80)	-	(320)	(220)	-
APAT after MI	31,530	25,680	22.8	30,380	3.8	1,10,620	1,01,230	9.3
Extra ordinary items	0	0	-	0	-	0	0	-
Reported PAT	31,530	25,680	22.8	30,380	3.8	1,10,620	1,01,230	9.3
Reported EPS	11.6	9.5	22.8	11.2	3.8	41	37	10.8
Margins (%)			(bps)		(bps)			(bps)
EBITDA	25.4	22.7	270	24.6	70	23.6	23.2	40
EBIT	20.9	19.2	170	20.2	60	19.6	19.6	-
EBT	20.8	20.0	90	20.6	20	19.9	20.9	(100)
PAT	17.0	16.1	90	16.8	20	15.7	16.8	(110)
Effective Tax rate	18.3	19.3	(100)	18.5	(20)	20.9	19.6	130

Source: Company, BOBCAPS Research

FIG 2 – MAR'20 OPERATING METRICS

(In US\$ terms)	Q4FY20 (% Contr. to Revenue)	Growth	
		QoQ (%)	YoY (%)
Revenue by Business Segment			
Mode 1	65.1	(1.3)	3.1
Mode 2	19.2	5.5	13.4
Mode 3	15.7	(0.6)	65.4
Revenue by Geography			
US	63.4	1.0	12.5
Europe	28.7	(1.7)	7.9
Asia Pacific	7.8	(2.5)	17.7
Revenue by Service Offering			
IT and Business Services	70.6	0.6	4.0
Engineering and R&D Services	16.3	(2.4)	9.7
Products & Platforms	13.1	0.0	92.5
Revenues by Industry			
BFSI	21.1	(2.3)	11.7
Retail	10.2	(1.0)	13.9

(In US\$ terms)	Q4FY20 (% Contr. to Revenue)	Growth	
		QoQ (%)	YoY (%)
Media, Publishing & Entertainment	8.3	(7.8)	7.8
Life Sciences	12.5	2.5	7.4
Energy Utilities - Public Sector	11.1	1.9	(16.5)
Manufacturing	20.7	(0.9)	32.1
Technology Services	16.2	7.3	(9.8)
Client Contribution to Revenues			
Top 5	15.1	(0.6)	(0.8)
Top 10	22	(1.8)	1.9
Top 20	32.1	(2.7)	7.3
	Mar'20	Dec'19	Mar'19
Quarterly Annualised attrition rate (%)	24.1	25.5	25.5
Total Employees (nos)	1,50,423	1,49,173	1,37,965
Gross Addition (nos)	10,278	11,502	14,249
Net Addition (nos)	1,250	2,050	5,637
Revenues by Contract Type (%)			
Time & material	31.7	32.2	37.3
Fixed Price	68.3	67.8	62.7

Source: Company, BOBCAPS Research

Valuation methodology

We pare FY21/FY22 EPS estimates by 8%/6% as we lower revenue and profitability assumptions to account for Covid-19 challenges. Our Mar'21 target price thus stands revised down to Rs 650 (from Rs 690), set at an unchanged FY22E P/E multiple of 14.2x (~20% and 30% discount to that for Infosys and TCS respectively).

In our view, HCLT offers relatively higher near-to-mid-term growth visibility than peers on the back of:

- its growing software (Mode-3) business which forms 15.7% of revenue and is relatively immune to Covid-led volatility,
- healthy large deal wins (the 14 contracts won in Q4FY20 will transition to revenue-bearing mode in Q2FY21), and
- its IMS heritage which offers unique positioning to leverage the cloud migration opportunity catalysed by the pandemic.

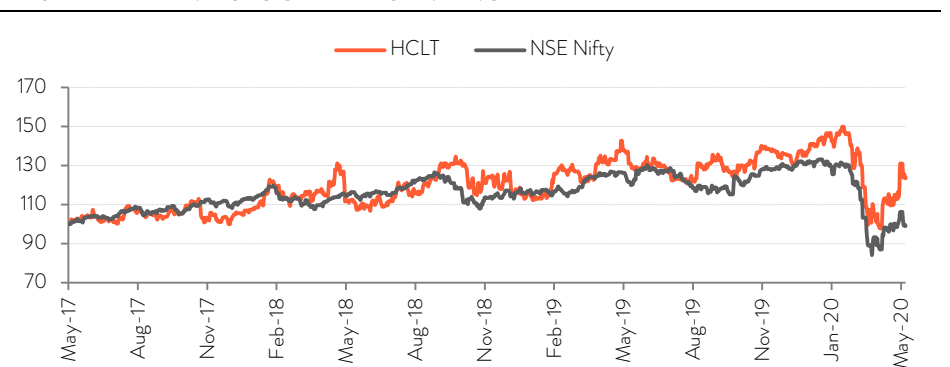
Moreover, HCLT's healthy balance sheet (US\$ 1.4bn net cash as at end-Q4FY20) and reassuring capital allocation policy offer added support. We reiterate BUY.

FIG 3 – REVISED ESTIMATES

(Rs mn)	FY21E			FY22E		
	Old	New	Change (%)	Old	New	Change (%)
Revenues (US\$ mn)	10,907	10,017	(8.2)	11,976	10,791	(9.9)
YoY growth (%)	9.5	0.8	-	9.8	7.7	-
Revenues	7,63,457	7,51,305	(1.6)	8,38,320	8,09,309	(3.5)
EBITDA	1,94,173	1,74,856	(9.9)	2,13,210	1,99,830	(6.3)
EBITDA margins (%)	25.4	23.3	-	25.4	24.7	-
EBIT margins (%)	19.3	18.2	-	19.6	19.6	-
Net profits	1,16,203	1,06,708	(8.2)	1,32,082	1,24,738	(5.6)
EPS (Rs)	42.8	39.3	(8.1)	48.7	46.0	(5.6)

Source: BOBCAPS Research

FIG 4 – RELATIVE STOCK PERFORMANCE



Source: NSE

Key risks

Downside risks to our estimates include:

- above-expected revenue contraction in IMS due to automation,
- above-expected HCL Software client attrition,
- an inability to renew existing contracts,
- a sharp decline in IT demand, and
- adverse currency movement.

FINANCIALS

Income Statement

Y/E 31 Mar (Rs mn)	FY18A	FY19P	FY20E	FY21E	FY22E
Total revenue	5,05,700	6,04,280	7,06,780	7,51,305	8,09,309
EBITDA	1,14,400	1,40,020	1,66,930	1,74,856	1,99,830
Depreciation	14,520	21,480	28,400	38,456	40,955
EBIT	99,880	1,18,540	1,38,530	1,36,400	1,58,875
Net interest income/(expenses)	0	(1,693)	0	0	0
Other income/(expenses)	11,110	7,720	1,790	2,182	3,123
Exceptional items	0	0	0	0	0
EBT	1,10,990	1,24,567	1,40,320	1,38,582	1,61,998
Income taxes	23,170	24,810	29,380	31,874	37,259
Extraordinary items	0	0	0	0	0
Min. int./Inc. from associates	0	0	0	0	0
Reported net profit	87,820	99,757	1,10,940	1,06,708	1,24,738
Adjustments	0	0	0	0	0
Adjusted net profit	87,820	99,757	1,10,940	1,06,708	1,24,738

Balance Sheet

Y/E 31 Mar (Rs mn)	FY18A	FY19P	FY20E	FY21E	FY22E
Accounts payables	0	0	0	0	0
Other current liabilities	1,06,460	1,26,860	2,59,090	2,62,957	2,83,258
Provisions	5,300	0	0	15,026	16,186
Debt funds	4,370	39,860	50,930	50,930	50,930
Other liabilities	0	0	0	0	0
Equity capital	2,812	2,812	2,812	2,812	2,812
Reserves & surplus	3,65,348	4,14,888	5,14,048	5,69,408	6,34,122
Shareholders' fund	3,68,160	4,17,700	5,16,860	5,72,220	6,36,934
Total liabilities and equities	4,84,290	5,84,420	8,26,880	9,01,133	9,87,308
Cash and cash eq.	16,930	59,290	48,430	1,10,470	2,35,032
Accounts receivables	1,22,570	1,46,100	1,77,720	1,95,545	1,99,556
Inventories	0	0	0	0	0
Other current assets	25,190	37,160	79,030	90,157	80,931
Investments	86,040	58,520	1,05,680	1,05,680	1,05,680
Net fixed assets	1,18,646	1,32,396	62,440	42,734	20,529
CWIP	0	0	0	0	0
Intangible assets	77,244	1,02,564	2,94,210	2,94,210	2,94,210
Deferred tax assets, net	0	0	0	0	0
Other assets	37,670	52,930	64,650	67,617	56,652
Total assets	4,84,290	5,88,960	8,32,160	9,06,413	9,92,589

Source: Company, BOBCAPS Research

Cash Flows

Y/E 31 Mar (Rs mn)	FY18A	FY19P	FY20E	FY21E	FY22E
Net income + Depreciation	1,00,510	1,20,740	1,39,340	1,45,164	1,65,693
Interest expenses	(4,450)	(4,480)	(1,790)	(2,182)	(3,123)
Non-cash adjustments	0	0	0	0	0
Changes in working capital	(12,340)	(24,660)	47,020	(13,026)	37,643
Other operating cash flows	(486)	(1,936)	(40,905)	0	0
Cash flow from operations	83,234	89,664	1,43,665	1,29,955	2,00,213
Capital expenditures	(53,210)	(34,340)	(1,50,090)	(18,750)	(18,750)
Change in investments	(13,180)	5,200	47,160	0	0
Other investing cash flows	44,016	(3,604)	1,790	2,182	3,123
Cash flow from investing	(22,374)	(32,744)	(1,01,140)	(16,568)	(15,627)
Equities issued/Others	0	0	0	0	0
Debt raised/repaid	(1,480)	36,230	0	0	0
Interest expenses	(38,750)	(39,860)	0	0	0
Dividends paid	(16,910)	(10,990)	(53,384)	(51,348)	(60,024)
Other financing cash flows	0	0	0	0	0
Cash flow from financing	(57,140)	(14,620)	(53,384)	(51,348)	(60,024)
Changes in cash and cash eq.	3,720	42,300	(10,859)	62,040	1,24,562
Closing cash and cash eq.	16,930	59,290	48,430	1,10,470	2,35,032

Per Share

Y/E 31 Mar (Rs)	FY18A	FY19P	FY20E	FY21E	FY22E
Reported EPS	31.5	36.7	40.9	39.3	46.0
Adjusted EPS	31.5	36.7	40.9	39.3	46.0
Dividend per share	8.0	14.7	16.4	15.7	18.4
Book value per share	132.1	153.5	190.5	210.9	234.7

Valuations Ratios

Y/E 31 Mar (x)	FY18A	FY19P	FY20E	FY21E	FY22E
EV/Sales	2.7	2.3	1.9	1.8	1.7
EV/EBITDA	12.1	9.8	8.2	7.9	6.8
Adjusted P/E	16.2	14.0	12.5	13.0	11.1
P/BV	3.9	3.3	2.7	2.4	2.2

DuPont Analysis

Y/E 31 Mar (%)	FY18A	FY19P	FY20E	FY21E	FY22E
Tax burden (Net profit/PBT)	79.1	80.1	79.1	77.0	77.0
Interest burden (PBT/EBIT)	111.1	105.1	101.3	101.6	102.0
EBIT margin (EBIT/Revenue)	19.8	19.6	19.6	18.2	19.6
Asset turnover (Revenue/Avg TA)	106.6	112.6	99.5	86.4	85.2
Leverage (Avg TA/Avg Equity)	1.4	1.4	1.5	1.6	1.6
Adjusted ROAE	26.5	25.4	23.7	19.6	20.6

Source: Company, BOBCAPS Research | Note: TA = Total Assets

Ratio Analysis

Y/E 31 Mar	FY18A	FY19P	FY20E	FY21E	FY22E
YoY growth (%)					
Revenue	8.2	19.5	17.0	6.3	7.7
EBITDA	11.0	22.4	19.2	4.7	14.3
Adjusted EPS	5.4	16.3	11.5	(3.8)	16.9
Profitability & Return ratios (%)					
EBITDA margin	22.6	23.2	23.6	23.3	24.7
EBIT margin	19.8	19.6	19.6	18.2	19.6
Adjusted profit margin	17.4	16.5	15.7	14.2	15.4
Adjusted ROAE	26.5	25.4	23.7	19.6	20.6
ROCE	24.6	25.2	23.9	20.4	25.3
Working capital days (days)					
Receivables	83	81	84	91	89
Inventory	0	0	0	0	0
Payables	102	92	130	165	164
Ratios (x)					
Gross asset turnover	5.3	4.8	7.3	14.3	25.6
Current ratio	1.8	2.3	1.4	1.7	1.9
Net interest coverage ratio	NA	NA	NA	NA	NA
Adjusted debt/equity	0.0	0.0	0.0	(0.1)	(0.3)

Source: Company, BOBCAPS Research

Disclaimer

Recommendations and Absolute returns (%) over 12 months

BUY – Expected return >+15%

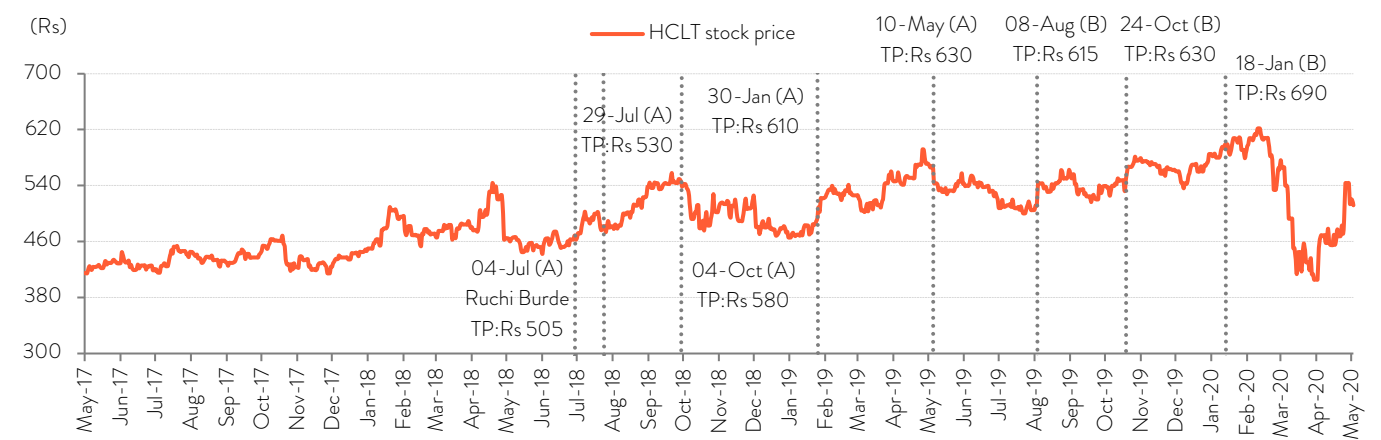
ADD – Expected return from >+5% to +15%

REDUCE – Expected return from -5% to +5%

SELL – Expected return <-5%

Note: Recommendation structure changed with effect from 1 January 2018 (Hold rating discontinued and replaced by Add / Reduce)

HISTORICAL RATINGS AND TARGET PRICE: HCL TECHNOLOGIES (HCLT IN)



B – Buy, A – Add, R – Reduce, S – Sell

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